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UNCLAS SECTION 01 OF 06 AMMAN 001620

SIPDIS

SENSITIVE

TREASURY FOR OASIA--MARSHALL MILLS, WON CHANG
USDOC 4520/ITA/MAC/ONE/COBERG
EXIM BANK FOR RITA MURRELL

E.O. 12958: N/A
TAGS: EFIN EAID ETRD JO
SUBJECT: JORDANIAN BANKS: WILL WEATHER STORM, BUT FACE LONG-TERM CHALLENGES

REF: A. A) AMMAN 793 B) JERUSALEM 566 C) JERUSALEM 144

D) 02 AMMAN 6852
¶B. E) 02 AMMAN 687

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SUMMARY

¶1. (SBU) While fundamentally sound, the Jordanian banking sector faces a number of short- and long-term challenges: Exposure to a military conflict with Iraq, a surplus of banks, high infrastructure costs, and implementation of modern banking and technological advances that are only now beginning to take hold. Having said that, under the watchful eye of the Central Bank of Jordan, the sector seems primed to weather the coming storm, and may well prosper in a post-Saddam environment.

THE SECTOR IN GENERAL

¶2. (SBU) Dominated by three major players--the Arab Bank (REF D), the Housing Bank, and the Jordanian National Bank, which account for 73% of the sector's assets (JD15.1 billion/$21.2 billion)--the Jordanian banking system continues to strive to become a healthy, progressive, customer focused service industry. It consists of 21 banks, three of them foreign, with 466 branches. In addition, Jordanian banks have 119 branches abroad, 60 of which are in the West Bank/Gaza. Jordanian banks have branches in the U.S., Lebanon, Cyprus, and the Gulf, with pending applications in Algeria and Syria. Most banks recorded profits last year at 10% or less, but expect a hard to flat year for 2003. The monthly bulletin of the Central Bank of Jordan (CBJ), available at www.cbj.gov.jo, contains timely statistical information on the sector.

¶3. (SBU) The banking sector has recently undergone consolidation, as the CBJ has taken over the administration of two banks, the Philadelphia Investment Bank and the Jordan Gulf Bank, due to mismanagement and losses brought on by the banks' exposure to the Shemaileh scandal, in which a Jordanian businessman arranged approximately $100 million in unsecured loans and subsequently fled the country (REF E). Foreign banks do not figure prominently--HSBC, Citibank, and the Egyptian Land Bank hold merely 2.4% of the system's assets--but do put some pressure on established banks to keep up with global innovations in technology and product offerings. There are two Islamic banks in Jordan: the Jordan Islamic Bank and the International Arab Islamic Bank, part of the Arab Bank Group, accounting for almost 4% of the sector's assets. Owing to an increase in banking awareness, deposits in Jordanian banks have grown by an average of 13% per year since 1980, from approximately JD700 million ($980 million) in 1980 to JD8.1 billion ($11.3 billion) in 2001. The share of bank deposits in the money supply, an indication of a country's rate of economic development, has increased to 62% last year from 49% in 1993.

IRAQ EXPOSURE

¶4. (SBU) Jordanian officials have repeatedly stressed to Embassy their concern about the banking sector's exposure to Iraq and the possible negative impact on the banking system of a military conflict. Banks' exposure to companies doing business with Iraq is approximately $370 million in terms of contracts yet to be executed, according to CBJ officials. The number three Jordanian National Bank (JNB) in particular is most exposed, and four or five smaller banks are also exposed to varying degrees. The CBJ fears that, once a conflict begins, OFF-related deliveries to Iraq, much of which were perishables, will cease, the contracts will be voided, the goods will spoil, and the Jordanian banks will

hold millions of dollars in what would become nonperforming loans. According to a top CBJ official, the Bank would be prepared to provide emergency loans to the JNB or other banks that suffered a temporary liquidity crisis because of OFF exposure. He hoped, however, that it would not come to this because of the very negative public signal it could send about the banking system's integrity, particularly during a period of expected political turmoil and with two banks already under CBJ control.

¶5. (SBU) The CBJ hopes that once a conflict begins, the UN will quickly establish new OFF procedures that would allow goods be delivered instead to Aqaba, where they could be held in a warehouse until hostilities ended and deliveries to Iraq could resume. This would allow Jordanian banks to continue to be paid from the OFF account. We have advised the Jordanian government to address this problem with the UN.

¶6. (SBU) Nase Khamhawi, President of the Association of Jordan Banks, told us he was most concerned over trade exposure with Iraq, and said that "many factories are set up just to do business with Iraq", and that banks that have relationships with these companies would be adversely affected by conflict. Ali al-Hosri, of the Export Finance Bank, echoed Khamis's concerns. He said that his bank was also studying alternative points of delivery in Jordan where the goods could be stored pending a resolution of hostilities. As early as December, he said, banks were working to reduce their potential exposure by not financing some contracts as they came up for review. Zachy Anderson, CEO of HSBC Middle East, said foreign banks in the region "do virtually no business with Iraq," but said he sensed that some local banks would be hurt. He added, however, that one unintended consequence of an Iraqi conflict might be the "bursting of the property bubble" in prosperous West Amman, given heavy exposure by banks to loans for homes built as investment property and the danger of default given adverse effects on the Jordanian economy at large in a prolonged conflict.

¶7. (SBU) In addition to the trade exposure, CBJ officials estimate that there are JD 600 million ($840 million) in Iraqi deposits in the Jordanian banking system, with JNB again being a leading recipient. The CBJ has put together a plan to ensure that these deposits, which amount to about 7% of total deposits, are not precipitously withdrawn during a military conflict. The plan includes freezing accounts of the Iraqi government, known front companies, and senior officials and carefully monitoring large and suspicious movements in other Iraqi accounts.

MAYBE A RUN, BUT NO PROBLEM

¶8. (SBU) Most bankers we spoke with expressed optimism that the sector would weather any crisis brought on by a war with Iraq. One executive, however, suggested that "it would take months for the sector to recover". He saw a worst case scenario in which a total shutdown of airspace would lead to hoarding of dollars. Khamhawi had the opposite view. He said that banks were well-prepared to handle the conflict. As in 1991, he and other informal observers opine, there would be a "small rush on the banks, maybe for a few days" and then customers would return to redeposit the withdrawn funds. CBJ officials believe that the Bank's $3 billion in foreign reserves provide a more than adequate cushion to cope with any short-term run on Jordanian banks.

TOO MANY BANKS

¶9. (SBU) Among the longer term issues is the "over-banking" of Jordan. With so many branches and bank offices, Jordan presently has about one bank per 10,000 people (compared to about one per 30,000 in the Gulf). CBJ Head of Banking Supervision Mai Khamis said many of these are weak, small, family-run banks that pose a risk to depositors and borrowers alike. To encourage consolidation, the CBJ doubled minimum capital requirements in 2002 to JD40 million ($56 million) in order to force the merger or acquisition of the weaker banks. She quickly added that the CBJ was not interested in the smaller banks combining with one another, making "one big, weak bank." Rather, Khamis said, the CBJ hopes that stronger banks take over smaller institutions when "opportunities present themselves". This in turn would lead to savings on overhead and operating costs, encourage efficiency and increased use of technology, and dilute the conservative influence of family-owned banks on a sector that's flush with liquidity. (NOTE: Talks are under way for the acquisition of Jordan Gulf Bank by the Arab Bank. Likewise, the Housing Bank is moving to acquire the Philadelphia Investment Bank, under CBJ administration since last year. END NOTE) Cairo Amman Bank has also indicated interest in the possibility of merging with one of the smaller banks if a financially-sound

candidate comes on offer.

INTEREST RATE SPREAD

¶10. (SBU) One of business people's main complaints is that borrowing rates remain relatively high despite a reduction in deposit and CBJ rates in recent years. The current CBJ discount rate is 4.5%. The average interbank loan interest rate stands currently at 2.875%. The average interest rate on consumer loans is 9.85%, with most loans having a tenure of five years or less. In addition, most banks charge an annual commission of 1%. The interest rate for deposits is 3.9%, and while commercial banks in Jordan have progressively lowered interest rates on both deposits and credit facilities in concert with U.S. interest rate drops, rates on deposits have dropped at a much faster clip. Since 1999, the interest rate on time deposits has declined from 7.9% to 3.9%, while credit rates have gone from 12.6% to 9.85% in the same period. Currently, the nominal spread between credit and deposit rates is 5.9%. Interest rate spreads are an indication of the general attractiveness of a country for investment and the ability of the private sector to finance investment activities.

¶11. (SBU) Citing an IMF study (Understanding the Margin Between Lending and Deposit Rates in Jordan), CBJ officials assert the spread between lending and deposit rates in Jordan is not especially high compared to other developing countries. (NOTE: Some spreads within the region bear this out: Bahrain, 7.6%; Lebanon, 6.5%; Morocco, 7.4%. In contrast: Egypt, 4.2%; Israel, 3.9%; Oman, 3.2%; Kuwait, 3%. END NOTE) Khamis told us that high operating costs fueled by excess labor rendered the sector as a whole inefficient in its management of overhead costs, typically as high as 4-5%, as it is "socially difficult" to fire anyone. She added that corporate taxes for banks, now at 35%, are higher than for any other sector. In addition, due to a history of nonperforming loans, banks must impose higher interest rates in order to offset their losses. Private bankers, as well as CBJ officials strongly resent recent high profile efforts by some GOJ officials, notably Economy Minister Samer al-Tawil, to jawbone" banks into cutting borrowing rates. They expect that over time the markets will do their work. However, as an Amman Chamber of Commerce official told us, that time may be too long in coming for some companies.

CREDIT AND CONSUMER PRODUCTS

¶12. (SBU) At the same time, credit as a share of GDP is low, and banks have been slow to introduce innovative new products. Bank credit extended in Jordan currently amounts to JD 5.2 billion ($7.3 billion), an average increase of 12% per year since 1980, and an indication that Jordan's traditionally tight credit market is loosening. Most loans go to general trade (JD 1.2 billion/$1.7 billion), construction (JD800 million/$1.1 billion), and industry (JD800 million/$1.1 billion). The banks, however, are quite liquid, with about JD15 billion ($11.2 billion) in total assets. Just under 2% of Jordanian loans are made by foreign banks. Central Bank officials say that Jordan is committed to implementing "Basel II" capital adequacy standards, although banks will need technical assistance to put in place appropriate internal rating systems.

¶13. (SBU) Local banks, pushed by foreign competition, are beginning to recognize the profitability of expanding consumer credit. Cairo Amman is emblematic of the push to pursue the consumer credit market, which officials say caters to Jordan's young population. C-A officials told us, for example, that a majority of the bank's 70,000 borrowers are government employees, "a good risk, because they have jobs and salaries for life." The bank is increasing its long-term lending as well; its 20-year loan portfolio expanded from $8 million to $21 million in 2002, and it established a real estate site linked to its webpage where prospective home buyers can view properties, calculate mortgage rates, and apply for home loans. (NOTE: According to bank figures, the average mortgage is JD30,000 ($42,000) at 10% interest for 20 years and requires 20% as down payment. END NOTE.) HSBC has just rolled out a 20 year mortgage product at 7.25% interest, the harbinger perhaps of further reduction of rates and a narrowing of the spread. Defaults on mortgages are rare as people do not want "to lose their dream home", as one banker told us.

¶14. (SBU) Auto loans can be problematic. Issued at 9% interest and requiring 30% of the price of the car for down payment, they also generally carry an annual charge of 10% of the principle of the loan, bringing the real interest rate closer to about 17%. These charges are not often disclosed until the contract for the loan is presented to the borrower, but, as there is currently no "truth in lending law" in

Jordan, car buyers have little recourse.

¶15. (SBU) Nonperforming loans, set by the CBJ at 90 days as opposed to the more common 180 days, make it difficult for banks to price their credit facilities to other than their traditional large, institutional customers. But Khamis defended the relatively short rating period and said that the level of nonperforming loans in the system at 15% is "unacceptable" and hoped to see the rate drop closer to 10%. She said that even the healthy Housing Bank has a 14% rate of nonperforming loans, and that lengthening the rating period would not matter as banks just make fresh loans to their favored clients in any case. Regarding specific sectors that may be more vulnerable in case of conflict, such as the tourism industry, one banker shrugged it off and said, "You can't own a hotel unless you own a bank", citing cross-ownership between the hotel and banking sectors. (NOTE: For example, the Sabih al-Masri family owns the Zara Hotel Company, and, due to partial ownership, has representatives on the Board of Directors the Cairo Amman Bank. The Muasher family, owners of the hotel chain that owns Marriott hotels in Jordan, has a spot on the Jordan National Bank board. End Note.) Indeed, according to CBJ figures, current sector exposure to tourism, hotels, and restaurants is relatively low, at JD174 million ($244 million).

CREDIT BUREAU LAW

¶16. (SBU) One of the major structural deficiencies in the banking system is the absence of a system for sharing credit information. As part of its FY 2003 cash transfer, the USG made the passage of the Credit Bureau Law "in principle" a condition precedent. The Cabinet passed the law in January 2003, and the Law is currently in the Legislative Bureau for final and thorough review. Ahead of final implementation of the Law, Khamis said, the CBJ maintains credit information on all borrowers with loans above JD50,000 ($70,000), information that is available to all banks upon request. The Association of Banks in Jordan is also in the process of establishing a credit bureau, which will grow out of a current database that tracks all loans over JSD30,000 ($42,000). There is also a nascent debt collection industry in Jordan.

¶17. (SBU) The use of checks as an instrument of transaction dropped by 3% in 2002, but has generally remained constant. Both the value and the percentage of returned checks have been steadily dropping as well, as most banks increase overdraft facilities, albeit at high (9%) interest rates. A private company working for a consortium of banks, and not licensed by the CBJ, maintains a database on bounced checks, as does the Association of Banks in Jordan (ABJ).

TECHNOLOGY CATCHING UP

¶18. (SBU) The use of ATMs has caught on in the Kingdom, with 325 ATMs now in use throughout the country. (NOTE: According to Cairo-Amman, each ATM replaces three to four employees, resulting in lower overhead and reducing the long-term utility of maintaining branches. END NOTE) Most of the larger banks are linking their branches to one another on-line, and many of them are planning to offer on-line banking once security and encryption concerns are ironed out. Concurrently, credit card penetration has increased as well as banks recognize the profit potential in consumer credit. According to Visa Jordan officials, 120,000 cards are currently in use, with an increase of 830% in the number of transactions since 1998. 3700 merchants are currently connected via POS (Point of Sale) units. The popularity in debit cards is also growing, especially among students.

SHEMAILEH

¶19. (SBU) The country was shaken early last year by the Shemaileh scandal, but CBJ officials said the effects of the scandal were receding, as the takeover of the Jordan Gulf Bank by the CBJ addressed one of the Shemaileh legacies (REF A). Khamis said the sector recovered some of the lost funds via the sale of various Shemaileh assets seized by GOJ authorities during the investigation and following his arrest. She noted the investigation was continuing, but winding down. Khamis stressed the way to prevent recurrence of fraud is by strengthening market discipline via strong corporate governance. However, she said this was difficult to accomplish in Jordan where bankers traditionally maintain relationships based on "who you are" rather than the soundness of a business's balance sheet.

¶20. (SBU) Khamis said that CBJ Governor Toukan is "unshakable" in his determination to protect depositors and

modernize and strengthen the Jordanian banking industry in order to prevent another "Shemaileh." She said that Toukan has the advantage of never having worked in the private sector, and thus "does not owe anyone anything." But given that some influential Jordanian bankers are former GOJ officials, she added, his job is complicated.

WEST BANK/GAZA EXPOSURE

¶21. (SBU) Khamis said Jordanian banks, particularly the Cairo Amman Bank and the Arab Bank (REF D), were highly exposed to West Bank/Gaza to the tune of about JD267 million ($374 million). She expressed outrage at a January Israeli Defense Force (IDF) action against an Arab Bank branch in the West Bank (REF C), and said "These are Jordanian banks!" She cautioned that "this sort of thing starts with one incident and then becomes the practice." (NOTE: On March 2, the IDF again conducted a raid on the Arab Bank. (REF B) End Note) She said that Jordanian banks have approximately 60 branches in West Bank/Gaza, and the Jordanian Dinar is the primary medium of exchange on the West Bank.

¶22. (SBU) Cairo Amman officials told us the bank is heavily exposed in Palestine, as one of the first to open on the West Bank in 1986. Counting their offices in Gaza, the bank has 19 branches in the Occupied Territories, with $500 million in the West Bank alone. In December, the Jenin branch, uninsured for acts of war, was hit by an Israeli shell marked for a nearby bomb-making facility, causing $100,000 in damage to the bank. The bankers said that business was bad, and that Cairo Amman was no longer making loans in the Territories, merely managing existing ones. "When loans become non-performing after 90 days," one official told us, "what can you do for someone from Nablus, who has been under curfew for 120 days." In addition, he said, "the economy is in recession, there is no new investment, and what loans we have are not being repaid. Things are bad."

REMITTANCES

¶23. (SBU) Bank officials told us that workers' remittances from abroad take a number of forms, according to bank officials. Most remittances, which come from the Gulf countries, enter via banks. Some of the funds are hand-carried by workers as they return. Money Grams are gaining in use, primarily by Filipino and Sri Lankan expats wiring money to their families back home. After a lull caused by the expulsion of Jordanian workers during and following the Gulf War, (a scenario most observers expect will not be repeated), remittances have steadily increased since 1992 and reached $1.7 billion in 2000, 20% of Jordan's GDP.

COMMENT

¶24. (SBU) As most things Jordanian, the banking sector feels the stress of having neighbors on either side that act as a real or potential liability on its balance sheet. Flush with reserves and relatively stable, however, the system can stand short term strains provided that, as in the last Gulf War, regional stability holds. In the longer term, the extent to which Jordanian banks continue to respond to market forces and innovate may lead to even greater opportunities for the Jordanian banks and their clients as a post-Saddam Iraq comes into focus. USAID is helping this process through a series of targeted technical assistance and training programs that should help modernize bank supervision and management, with the ultimate goal of loosening currently trapped liquidity for productive investment in economic activities.

GNEHM